

SUMMARY ANALYSIS OF AMENDED BILL

Franchise Tax Board

Author: Wesson, et. al. Analyst: Marion Mann DeJong Bill Number: AB 2747

Related Bills: See Prior Analysis Telephone: 845-6979 Amended Date: 05-16-2002

Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: Motion Picture Production Wages Paid Credit

DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced/amended _____.

X AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.

X AMENDMENTS DID NOT RESOLVE THE DEPARTMENT'S CONCERNS stated in the previous analysis of bill as amended April 30, 2002.

X FURTHER AMENDMENTS NECESSARY.

DEPARTMENT POSITION CHANGED TO _____.

X REMAINDER OF PREVIOUS ANALYSIS OF BILL AS AMENDED April 30, 2002, STILL APPLIES.

OTHER – See comments below.

SUMMARY

This bill would create an income tax credit for wages paid in connection with the production of a motion picture in California. If unable to use this credit, the taxpayer could:

- assign the credit to another taxpayer;
- apply the income tax credit against any sales or use taxes owed; or
- receive a refund of any sales or use taxes paid.

SUMMARY OF AMENDMENTS

The May 16, 2002, amendments made the following changes:

- Clarified that wages paid or incurred on or after January 1, 2004, would qualify for the credit.
- Specified that only one taxpayer, the one that holds legal title to the motion picture, would be eligible for the credit with respect to each motion picture.
- Accepted department-recommended technical changes.

The May 16, 2002, amendments resolved the implementation concern that the structure of the bill was inconsistent and would not allow the credit for wages paid between January 1, 2004, and June 30, 2004, as the author intended. The amendments also resolved the implementation concern that more than one taxpayer could qualify for the credit based on the same wage expense. Finally, the amendments resolved the first three issues discussed under "Technical Considerations" in the department's analysis of the bill as amended April 30, 2002.

Board Position:

<u> </u> S	<u> </u> NA	<u> </u> NP
<u> </u> SA	<u> </u> O	<u> </u> NAR
<u> </u> N	<u> </u> OUA	<u> X </u> PENDING

Legislative Director

Date

Brian Putler

6/4/02

The “This Bill,” “Implementation Considerations,” and “Technical Considerations” discussions and “Economic Impact” from the department’s prior analysis have been revised to reflect the amendments and are provided below. The remainder of the department’s prior analysis still applies. The Board position remains pending.

Summary of Suggested Amendments

Amendments are needed to resolve the implementation concerns discussed in this analysis. Department staff is working with the authors and the Governor’s office to help them create a credit that meets the needs of industry but that can be administered by the department.

ANALYSIS

THIS BILL

This bill would create an income tax¹ credit equal to a percentage of wages paid by the taxpayer that holds legal title to the motion picture in relation to the production of a motion picture in California.

The credit would equal 15% of wages paid to qualified individuals during the taxable year with respect to a motion picture. For qualified individuals in a motion picture located in an enterprise zone, the credit would equal 25% of wages paid to qualified individuals during the taxable year with respect to that motion picture. For each motion picture, the maximum amount of wages per qualified individual that can be taken into account in computing the credit is \$25,000.

“Qualified individuals” would be individuals who render personal services in an activity related to the production of a motion picture. Individuals related to the taxpayer would not qualify for the credit. To qualify, the individual must perform substantially all of his or her services during the year in an activity related to a motion picture that qualifies for the credit.

Wages qualifying for the credit would include:

- Compensation paid to an employee on or after January 1, 2004, for services performed in California while the employee is a qualified individual.
- Employee fringe benefit expenses that are allocable to services performed in California.
- Payments made to an entity (i.e., personal service corporations, payroll service corporation, or any entity receiving wages on behalf of a qualified individual) on or after January 1, 2004, for services performed in California by qualified individuals.
- Compensation paid to independent contractors on or after January 1, 2004, who are qualified individuals for services personally rendered in California.

Cost paid for various activities specified in the bill that are unrelated to the production of a motion picture would be excluded from wages that qualify for the credit.

¹ This bill would provide a credit under both the income tax and the franchise tax. For purposes of this analysis, the reference to “income tax” includes the “franchise tax.”

Motion pictures qualifying for the credit would be motion pictures as defined in Section 6010.6(b)(3) of the Revenue and Taxation Code (the sales and use tax law) that meet both of the following additional requirements:

- The total cost of wages of the motion picture, excluding specific costs, is more than \$200,000, but less than \$10 million. These amounts will be indexed annually for inflation. For purposes of this test, each episode of a television series is considered to be a separate motion picture.
- 50% of the total wages of the production are wages that qualify for the credit.

If the qualified wages under this section also qualify for a different income tax credit, the taxpayer could claim only this credit for the wages paid to any employee and not the other income tax credit.

Only one taxpayer, the one that holds legal title to the motion picture, would be eligible for the credit with respect to each motion picture. In the event the taxpayer was unable to use some or all of an earned credit, the taxpayer may elect to assign any portion of the unused credit to members of the same controlled group. Excess credit amounts could be carried forward indefinitely. Alternatively, the taxpayer could elect to apply the income tax credit against a sales or use tax liability or request a refund of sales or use tax already paid equal to the income tax credit.

IMPLEMENTATION CONSIDERATIONS

The department would be unable to administer this bill as currently drafted. Department staff has identified numerous implementation concerns for this bill. Department staff is working with the authors and the Governor's office to resolve these concerns. The following is a brief discussion of the most significant issues. Additional issues may be identified as the bill is refined and moves through the legislative process.

- Taxpayers and the department would have difficulty determining if a motion picture qualified the taxpayer for the credit. The credit is based on a percentage of wages paid during the taxable year with respect to a "qualified motion picture production." To be a qualified motion picture, the *total* cost of wages of the motion picture must meet certain dollar limits and 50% of the *total* wages of the production must be incurred for services performed in California. Taxpayers and the department would not be able to determine if a motion picture was a "qualified motion picture" until the production was complete. The period for production could cross several taxable years and therefore require the filing of amended returns to claim the credit (if the statute of limitations remains open for the year the expenses were incurred). In addition, more than one taxpayer could be involved with the production of a motion picture. Unless the taxpayers were required to share the wage information with each other and the department, it would be difficult to determine if the wage limitations were met and the motion picture qualified. Moreover, unless taxpayers were required to share this information with one another, disclosure issues would arise if the department sought to challenge qualification for the credit for one taxpayer where the disallowance was based on confidential tax information obtained from another taxpayer during the course of audit.

- This bill allows to a “qualified person” a credit in an amount equal to 15% of the amounts paid or incurred by “the taxpayer” for qualified wages. It is unclear whether all amounts the author intends to be eligible for the credit would be considered wages paid by a single entity. In addition, limiting the credit to only one taxpayer conflicts with provisions that allow assignment of the credit to another taxpayer.
- Although the bill defines “qualified person” as the holder of legal title to a qualified motion picture, department staff believes there might be more than one person with “legal title” to a qualified motion picture. It is unclear whether the concept of a single holder of “legal title to a qualified motion picture” reflects how motion pictures are produced. Staff believes the author intends to allow a credit to the person who has production rights to the picture.
- “Qualified wages” includes “compensation” and “fringe benefits.” Compensation generally includes “fringe benefits.” “Wages” may be more appropriate than “compensation.” Further, it is unclear whether all fringe benefits or a portion of fringe benefits would be considered “qualified wages.” Unclear provisions can lead to disputes between taxpayers and the department.
- It is unclear whether the increased credit for enterprise zones would be 25% or 40% (15% plus 25%) of wages. Further, it is unclear what is meant by a motion picture “located” in an enterprise zone. This could mean the picture must be filmed in the zone, or the services for which wages are paid must be performed in the zone. It is also unclear whether all activities or only a majority of activities must be located in the zone.
- This bill allows the credit to be assigned to any member of a commonly controlled group. It’s unclear what limitations, if any, would be applicable regarding this assignment among members of a commonly controlled group.

For example, it is unclear what would happen if a taxpayer assigns a credit and the credit is partially or completely disallowed in a subsequent audit by the department. The bill should clarify the department’s legal authority to adjust the tax liability of the assignee and reclaim the credit amount, with interest, from the assignee, especially if the assignor is either no longer in existence or no longer subject to California’s taxing jurisdiction. Moreover, since there may be occasion where the department’s audit of the assignor taxpayer’s return may occur after normal expiration of the statute of limitations (i.e., under a waiver), it might become necessary for the department to request waiver of the assignee’s statute of limitations to prevent the department from being foreclosed from adjusting the assignee’s tax liability when the department determines that part or all of the claimed credit should never have been allowed. Further, the department would need to be specifically authorized to disclose the necessary confidential tax information of the assignor to the assignee if such situation arose. Conversely, the assignee would statutorily need authorization to obtain tax information from the assignor about the circumstances surrounding their claiming of the credit that was assigned in order to defend a subsequent proposed adjustment by the department.

Alternatively, if the claimed credit of the assignor is disallowed only in part, it is unclear how this disallowance would be allocated between the assignor and the assignee, especially if the statute of limitations has expired for one, but not both, of the affected taxpayers.

The provision that allows the credit under the Personal Income Tax Law (PITL) to be assigned to one or more taxpayers is ineffective. The bill limits the assignment to other taxpayers in a controlled group of corporations. Individuals cannot be members of a controlled group of corporations. Furthermore, corporations are not subject to the PITL. Consequently, only a taxpayer subject to the PITL can use any credit against the tax imposed under the PITL.

The bill does not specify when the assignee taxpayer can use the assigned credit. It could be used in the same year as the assignor earned the credit or it could be used in the taxable year succeeding the taxable year of assignment and subsequent taxable years, similar to a carryover.

A commonly controlled group is not necessarily the same as a unitary group if the tests of unity are not satisfied during the year. The bill does not specify how the assignment would occur in this case. In addition, the bill does not specify what would happen if a member subsequently entered or left the group.

- This bill would create a system of "California tax benefit transfers" similar to the old federal safe harbor leasing regime. However, tax credits transferable under federal safe harbor leasing rules were limited to tax credits for the purchase of certain property and the transfer was accomplished by a nominal sale-leaseback of that property that thereby defined the tax consequences of the tax benefit transfer as between related parties. This credit is based on wage expenses. In the absence of clarification, disputes may arise between taxpayers and the department as to the proper tax treatment of consideration paid in connection with the transfer of a credit under this bill.
- The bill allows a taxpayer to elect to apply the income tax credit against a sales or use tax liability or request a refund of sales or use tax already paid equal to the income tax credit. The mechanics of the election should be refined to require a formal election on an originally filed return in the form and manner prescribed by the Franchise Tax Board in forms and instructions.
- The bill allows a taxpayer to elect to apply the income tax credit against a sales or use tax liability or request a refund of sales or use tax already paid equal to the income tax credit. However, the bill does not specify what is to be done if the income tax credit is partially or completely disallowed in a subsequent audit by the department. Further, the sales and use tax refund provision refers to the Board of Equalization's authority to recover any "erroneous" refund, but it is unclear whether a determination by the department would constitute an "erroneous" refund within the meaning of the law administered by the Board of Equalization. The bill should specify how the income tax credit and the election to receive a sales tax refund are intended to be coordinated. In addition, the bill should specify which agency (the department or the Board of Equalization) is to make the determination of whether a sales or use tax refund that has been granted is considered "erroneous" and thus capable of recovery through the sales tax "erroneous" refund authority.
- The definition of qualified individual does not work as the author intends. The definition requires "substantially all" of the individual's activities performed to be in relation to a qualified motion picture. First, the term "substantially all" is not defined, and thus the department is unsure as to when this standard would be satisfied. Second, if an actor worked on three films during the year, one in California that meets the requirements to be a "qualified motion picture" and the other two films in Canada, none of that actor's wages could be included in the credit computation since the "substantially all" standard would clearly not be met. If the same actor only worked on two films, one in California and one in Canada, the lack of a definition for "substantially all" would make it difficult to determine if that actor's wages could be included in the credit computation. As a result, it appears that the term "substantially all" should simply be removed from the definition.

- The definitions in this bill use terms and phrases that appear to be industry-specific, e.g. “new-use,” “reuse,” “clip use,” “delayed or residual compensation,” “turnaround,” etc. If there is a “dictionary” of motion picture industry terms, it might be helpful to identify a specific source for these terms and to specifically tie the interpretation of these terms under this bill to those external sources by explicit cross-references within the bill.
- This bill does not limit the number of years for the carryover period. The department would be required to retain the carryover on the tax forms indefinitely because an unlimited credit carryover period is allowed. Recent credits have been enacted with a carryover period limitation since experience shows credits typically are exhausted within eight years of being earned. Further, due to the assignment and refund provisions in this bill, a long carryover period may be less necessary than in other similar credit provisions.

TECHNICAL CONSIDERATIONS

The purpose of subdivision (h) is unclear, but appears to prevent the taxpayer from claiming more than one credit. Since subdivision (f) already makes this restriction, subdivision (h) appears to be unnecessary and should be deleted. In addition, it should be noted that subdivision (f) would require taxpayers to claim this credit and forgo any other wage credit available, regardless of which credit is more beneficial to the taxpayer. The author might consider amending subdivision (f) to allow a taxpayer to choose one wage credit.

ECONOMIC IMPACT

Revenue Estimate

The estimated revenue loss increased from the prior analysis by a total of \$95 million; fiscal year 2004-05 increased \$10 million, fiscal year 2005-06 increased \$75 million, and fiscal year 2006-07 increased \$10 million. The increased losses occurred for two reasons. First, the May 16, 2002, amendments clarified the author’s intent to allow wages paid from January 1, 2004, to June 30, 2004, to be included in the credit base. Second, the prior estimate incorrectly assumed that the taxpayer’s wage expense deduction would be reduced by the amount of the credit. The bill does not require such a reduction; the taxpayer can claim both this credit and any other deduction available with respect to the same wage payment.

The May 16, 2002, amendments limiting the credit to one taxpayer did not impact the revenue estimate for two reasons. First, the prior estimate did not include revenue losses attributable to more than one taxpayer claiming the credit for the same wage expense. Second, the definition of “qualified wages” is broad enough to include any payments made to independent contractors, subcontractors, and other entities; to the extent those payments are ultimately attributable to wages.

The revenue impact of this bill is estimated to be as shown in the following table:

Revenue Impact of AB 2747, As Amended May 16, 2002 Effective July 1, 2004 \$ Millions				
2003-04	2004-05	2005-06	2006-07	2007-08
-\$0	-\$25	-\$175	-\$110	-\$115

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Revenue Discussion

The revenue impact of this credit would depend on the amount of qualified wages paid beginning on January 1, 2004, and through November 30, 2010. Qualified wages is estimated as the product of the number of employees in the film/video industry, the average weekly wage, the number of work-weeks per year, the \$25,000 wage cap, and the \$10 million production cost cap.

The amount of qualified wages for the 2005 tax year is projected to be \$690 million derived as follows:

23,686 qualified employees X \$1,407 Average Weekly Wage X 50 Weeks X 41% Adjustment Factor
= \$690 million qualified wages

The adjustment factor of 41% includes the \$25,000 wage cap and the \$10 million production cost cap.

The amount of credits generated for the 2005 tax year is projected to be \$103 million as follows:

\$690 million qualified wages X 15% credit rate = \$103 million

This amount of generated credit is further adjusted for credit utilization rates by corporations and for cash-flow reductions in estimated tax payments throughout the year to arrive at the fiscal year estimates above.

The Film and Television Action Committee (FTAC) provided an estimate for the amount of wages that would qualify under this bill. For the year 1998, FTAC estimated that total wages for qualified projects would be approximately \$1,429 million, about 12% of the wages paid to California employees in industry SIC 781 (Motion Picture and Video Tape Production). Based on the weekly wage data \$1,292 from EDD, employment in qualified projects is estimated at 22,124 persons. This level of employment is assumed to stay unchanged from 1998 to 2002. From 2002 onward, employment is assumed to grow at 2.3% annually. Average weekly wages for the future years are assumed to grow at the same rates as the Consumer Price Index.

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